FIDUCIARY OBLIGATIONS

# Fiduciary obligations and constructive trusts: Attribution of illegality

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English law imposes strict obligations on fiduciaries. Undivided, single-minded loyalty is often cited as the core, or 'distinguishing' obligation: see *Mothew v Bristol & West Building Society* [1996] at 18.

Company directors are fiduciaries and are subject to the variety of fiduciary obligations imposed upon them by the common law, together with those set out in the Companies Act 2006. Their statutory duties include the duty to avoid a conflict of interest (s175), specifically stated to apply to the 'exploitation of any property, information or opportunity'.

What is the purpose of the law of fiduciary obligations, and the statutory duties set out in the Companies Act 2006? Such an analysis may, usually, be limited to academic circles. But when one is seeking to attribute to a company the illegal acts of its directors, an understanding of the purpose of the underlying rule of law (in this case, the law of fiduciary obligations and the duties of company directors) is crucial and is at the heart of the Supreme Court's analysis in *Crown Prosecution Service v Aquila Advisory Ltd* [2021].

## Background

The case concerned the actions of two company directors of Vantis Tax Ltd (VTL) who constructed a scheme by which they dishonestly facilitated and induced others to submit false claims for tax relief. The objective of the scheme was to take advantage of s587B of the Income and Corporation Taxes Act 1988. Section 587B allows an individual to receive tax relief if they transfer shares in a trading company on a recognised stock exchange to a charity, where the value of the shares at the time of transfer to the charity is higher than the value paid by the shareholder on the purchase of the shares.

To take advantage of this, the directors would form a company in which taxpayers would subscribe for shares at a relatively nominal price. That company would then purportedly acquire assets which would increase its share price, following which the shares would be given to charity. The taxpayer would then claim a tax relief calculated by reference to the difference between the price at which the share was purchased by that taxpayer, and the share price at the time of the transfer of the share by that taxpayer to charity.

The task therefore was to find assets which could be purchased so as to increase that company's share price. One such asset was a piece of computer software, which had been developed as part of one of the directors' business plan. The rights to the intellectual property (the IP) in the software at all material times belonged to VTL.

The scheme had various versions. The first involved the incorporation (in Jersey) of Clerkenwell Medical Research plc (Clerkenwell). Clerkenwell's purpose was said to be the acquisition and exploitation of the IP. Various clients of VTL subscribed for shares in Clerkenwell.

Notwithstanding the fact that the rights to the IP belonged to VTL, the directors arranged for a purported assignment of the IP rights to Clerkenwell from a fictitious trust known as the 'Richardson Trust', for the price of £500,000. The consideration was paid by cheque, signed by the directors on behalf of Clerkenwell, and made out to the trustee of the Richardson Trust, being one of the directors' wives.

The Richardson Trust, however, did not exist, and the owner of the IP was in any event VTL. The £500,000 was then applied for the benefit of the directors (and their wives).

To complete the scheme, the taxpayer subscribers in Clerkenwell needed to donate their shares to charity. VTL advised its clients that the value for each share should be given in the transfer form as £1, which was higher than the initial purchase price, and that £1 per share was to be the amount claimed on their tax returns. This valuation was false. Clerkenwell did not own the IP, and so the inflation of its value based on the acquisition of the IP was fraudulent. In ignorance of this fact, the taxpayers donated the shares to charity, and successfully claimed the tax relief.

Throughout 2005 and 2006 the directors replicated the scheme using different companies, with each new company purportedly purchasing the IP from Clerkenwell. In total, £4.55m (the funds) was raised through this scheme, which amount made its way into the hands of the directors and their wives.

The scheme was clearly fraudulent. It amounted to an offence of cheating the public revenue (as the revenue granted tax relief to the taxpayers which was not warranted). It also amounted to a breach by the directors of their fiduciary duties, in that they had exploited a commercial opportunity belonging to VTL (the use of the IP) to make a secret profit for themselves (ie, the £4.55m).

The directors were charged and found guilty by the criminal courts. Following their conviction, the CPS sought confiscation orders under the Proceeds of Crime Act 2002 (POCA) against the directors, and each was ordered to pay certain amounts to HMRC.

Aquila, however, standing in the shoes of VTL having purchased its proprietary rights, asserted that it had a proprietary claim to the funds which was in priority to the CPS's rights under the confiscation orders, as those orders did not give the CPS any form of proprietary interest in the assets of the directors.

## The proceedings

In the High Court, Mann J decided that the claimant, Aquila, which had acquired the proprietary rights of VTL, was entitled to assert a proprietary claim to the funds. Accordingly, Mann J granted a declaration that the funds were held by the directors and their wives from the time of their receipt on constructive trust for VTL. The CPS appealed.

It was accepted by the CPS that what the directors had done amounted to a breach of fiduciary duty, and that the consequence of that breach was that VTL had a proprietary claim to the funds on a constructive trust (see *FHR European Ventures LLP v Cedar Capital Partners LLC* [2014]). It was also accepted that the confiscation orders did not give the CPS any proprietary interest in the available assets of the directors. But the CPS submitted that the trial judge should have attributed the actions of the directors to VTL, and therefore treated VTL's claim to recover the proceeds of the crime as barred by the principles of illegality. This would have allowed the CPS to pursue the directors personally under the confiscation orders. The Court of Appeal rejected the CPS's submission that the directors' actions should be attributed to VTL. Relying on the judgment of the Supreme Court in *Jetivia SA v Bilta (UK) Ltd* [2015], the court held that:

> *… a director sued by a company for loss caused by a breach of fiduciary duty cannot rely on the principles of attribution to defeat the claim even if the scheme involved the company in the fraud or illegality.*

## Proceedings in the Supreme Court

The CPS's argument before the Supreme Court was as follows:

- the fraud of the directors should be attributed to VTL in circumstances where VTL has suffered no loss, but has rather stood to profit from the illegal acts of its directors by obtaining a proprietary interest in the proceeds of the crime which the directors committed; and
- the regime established by POCA should not permit VTL to benefit from the profits generated by the criminal activities of its directors.

## Attribution of illegality

Before we consider the court's ruling on this key issue, it is necessary to go back to first principles.

An agent who makes a secret profit in breach of fiduciary duty holds that secret profit on constructive trust for its principal (*Keech v Sandford* [1726]). This gives the principal a proprietary interest in the profit in question. In other words, the principal has a right to make a claim against the profit or asset, and not simply a personal claim against the agent for compensation. A company director also owes fiduciary duties to the company, just as an agent does to their principal, the relevant duty being the duty of undivided loyalty.

That is the rule, but what is its purpose?

The purpose was summarised by Lord Neuberger in *FHR*:

> *The agent owes a duty of undivided loyalty to the principal… The principal is thus entitled to the entire benefit of the agent's acts in the course of his agency… The agent's duty is accordingly to delivery up to his principal the benefit which he has obtained, and not simply to pay compensation for having obtained it in excess of his authority. The only way that legal effect can be given to an obligation to delivery up specific property to the principal is by treating the principal as specifically entitled to it.*

The purpose, therefore, is to give effect to the obligation of the agent to deliver up the relevant property, and protect the company from exploitation by its directors. The rule, Lord Neuberger explained:

> *… is justified on the basis that equity does not permit an agent to rely on his own wrong to justify retaining the benefit: in effect, he must accept that, as he received the benefit as a result of his agency, he acquired it for his principal.*

An understanding of the purpose of this rule, and the purpose of fiduciary obligations in general, is essential to an understanding of the Supreme Court's decision. This is because of the ruling in *Jetivia*. *Jetivia* is the leading decision on attribution of illegality.

Attribution is the principle that the acts of some person may be attributed to some other person. Where illegality is attributed, in this case the illegality of the directors, the party to whom those illegal actions are attributed is barred from seeking recovery of sums deriving from that illegal activity.

In *Jetivia*, the liquidators of a company, Bilta, sought to recover sums paid out as part of a VAT fraud to a Swiss company. The Swiss company sought to defend the claim for recovery on the basis that the illegal actions of Bilta's directors (in the VAT fraud) ought to be attributed to Bilta itself, so as to bar its action for recovery. The Swiss company's defence failed. Lord Neuberger held that on the question of attribution (para 7):

> *Where a company has been the victim of wrongdoing by its directors… then the wrongdoing, or knowledge, of the directors cannot be attributed to the company as a defence to a claim brought against the directors by [the company] for the loss suffered by the company as a result of the wrongdoing…*

Noting that the defence of illegality is highly sensitive to context and public policy, the court stated that where a company is pursuing a claim against a director for breach of duty (para 206):

> *… it would defeat the company's claim and negate the director's… duty to the company if the act or state of mind of the latter were to be attributed to the*

> *company and the company were thereby to be estopped from founding on the wrong.*

Indeed, Lord Mance held that:

> *As Lord Hoffman made clear in [Meridian Global Funds Management Asia Ltd v Securities Commission [1995] 2 AC 500], the key to any question of attribution is ultimately always to be found in considerations of the context and purpose. The question is: whose act or knowledge or state of mind is for the purpose of the relevant rule to count as the act, knowledge or state of mind of the company?*

As for Lord Toulson and Lord Hodge, they considered that the defence of illegality was sensitive to the context and to competing aspects of public policy. They held that if the defence of illegality was permitted to succeed on the facts in *Jetivia*, then:

> *… the courts would defeat the very object of the rule of law… and would be acting contrary to the purpose and terms of sections 172(3) and 180(5) of the Companies Act 2006.*

This issue of the context and purpose of the underlying rule of law (in our case that of fiduciary obligations and constructive trusts) was dealt with at length in the Supreme Court in *Singularis Holdings Ltd (in liquidation) v Daiwa Capital Markets Europe Ltd* [2019]. Lady Hale, delivering the judgment of the court, held that (para 30):

> *… the key to any question of attribution was always to be found in the considerations of the context and the purpose for which the attribution was relevant…*

In short, therefore, illegality cannot be attributed where doing so would negate the purpose of the core underlying rule – in this case, 'the duty owed by an officer to the company which the officer serves' (at para 71). The purpose of the rule meant that the company could not be identified with its officer. It would negate entirely the protection afforded to companies by the law of fiduciary obligations (at para 75):

> *The fact that a director who breaches a fiduciary duty will be stripped of profit is a powerful means of guarding against the director's temptation of self-interest.*

## The Supreme Court's ruling

The CPS's first ground of appeal (the illegality ground) was that the present case should be distinguished from *Jetivia* on the basis that the illegality of the directors should be attributed to the company in circumstances where the company is seeking to profit from its own directors' crimes by obtaining and benefiting from the very proceeds of that crime. In short, the CPS submitted that *Jetivia*, properly understood, does not allow a principal (VLT, now Aquila) to profit from the illegality of its agents (the directors) while at the same time denying attribution of that illegality to the company.

The CPS's second ground of appeal (the POCA ground) centred on the notion that as a matter of public policy Aquila ought not to succeed since this would directly oppose the regime as established by POCA that not only criminals but also third parties must not profit from crime. As a subsidiary point, the CPS also argued that the same POCA policy concerns should have led the lower courts to decline to grant declaratory relief to Aquila on the constructive trust since this is a discretionary remedy.

The Supreme Court dismissed the appeal on all grounds.

## Illegality

With respect to the illegality ground, the court found first that a confiscation order does not actually involve the confiscation of anything; it merely creates an obligation to pay a sum of money. Consequently, it cannot be regarded as a proprietary right that can in any respect override the proprietary right that had arisen for VTL by virtue of the secret profits that were held on constructive trust by the directors. The court explained that the constructive trust created by virtue of the directors' breach of fiduciary duty 'exists to ensure compliance with, and is imposed in consequence of, the directors' fiduciary duty to the company' (para 74).

The court then confirmed the approach as set out in *Jetivia*, namely that in proceedings by a company against its directors for breach of fiduciary duty, the fraud of the directors could not be attributed to the company. On this, much was made by the CPS that the court should distinguish this case from *Jetivia* and instead follow the ruling in *Patel v Mirza* [2014]. The court, while recognising that the law of illegality had been recently restated in *Patel*, declined to agree that there was anything in *Patel* that rendered the illegality reasoning in *Jetivia* incorrect law. Moreover, the CPS sought to establish an exception to the reasoning in *Jetivia*, claiming that where a director's conduct in breach of fiduciary duty was intended to or did secure a financial benefit for the company, the illegality defence should apply. Lord Stephens rejected the CPS's attempt to create an exception, stating that 'it is an unwarranted distinction which undermines the clarity and simplicity of the law in relation to attribution' (at para 72) which would (at para 74):

> *… undermine that fiduciary duty if the director could establish that a constructive trust did not arise purely on the basis that the director also intended that the company should make a financial profit…*

On the illegality ground, therefore, Lord Stephens concluded that (para 80):

> *… the reasoning of this court in [Jetivia], albeit concerned with loss-based claims rather than claims to strip profits, applies with equal force to the breach of fiduciary duty which is the subject of this decision. [Jetivia] is authority for the proposition that the unlawful acts or dishonest state of mind of a director*

> *cannot be attributed to the company so as to afford the director an illegality defence to the company's claim against him for breach of fiduciary duty…*

In this regard, it is important to note that the court found that the CPS could have no better defence to Aquila's claim than the former directors would have had. The CPS's rights were dependent on the rights of the former directors.

## POCA

The focus of this article is the court's consideration of what we might call the 'attribution of illegality' issue. However, it is worth summarising the Supreme Court's findings in relation to POCA, if only to equip private client lawyers with some useful knowledge in case things go very wrong indeed for their clients.

Part 2 of POCA makes provision for confiscation orders, and requires the Crown Court to make such orders in certain circumstances (such as where those found guilty of a crime have received some benefit from that crime).

The overarching principle of POCA however, according to the Supreme Court, is that a confiscation order does not interfere with existing third-party property rights. There is support for this within the specific provisions of POCA, but also in the ruling of Lord Hobhouse in *In re Norris* [2001], which confirmed that confiscation orders should not interfere with the property rights of innocent third parties.

This was therefore shaky ground for the CPS's submission that the court's determination that the funds were held on constructive trust for VTL (and therefore Aquila) was inconsistent with the aim and purpose of POCA. To bolster the argument, it was further suggested that even if there was a constructive trust in favour of VTL, the use or possession of that beneficial interest would amount to money laundering offences contrary to ss327 and 329 of POCA.

The Supreme Court rejected this argument. It was held not to be permissible to alter existing property rights under the constructive trust on the basis of public policy considerations deriving from POCA (ie, on the basis of the CPS's interpretation of the aim and purpose of the legislation). In support of this decision, the Supreme Court noted the decision in *R (Best) v Chief Land Registrar* [2015] that:

> *POCA is a separate regime operating according to its own, distinct concepts and with its own, distinct procedures and safeguards, and is not material to the issue before us…*

– in other words, this was a civil claim, and it was not for the court in this case to determine if an offence had been, or would be, committed (para 86).

Finally, as a practical point, it should be noted that it was open to the CPS to have instituted criminal proceedings against VTL itself, and to have sought an order under POCA to restrain or prevent VTL from dealing with its proprietary rights in the funds. But it had not done so. As Mann J had put it:

> *… it is… POCA which determines whether VTL/Aquila lose the right which the directors' acts give them, not some more generalised considerations of public policy (or illegality). If the Act contains provisions which… have the effect vis-à-vis VTL of depriving it of its proprietary rights, then VTL/Aquila loses those rights. But those rights have to be invoked against VTL/Aquila in a proper way.*

Finally, with respect to the CPS's contention that declaratory relief should not have been granted, Lord Stephens noted that even if the declaratory relief should be regarded as discretionary, the discretion had been properly exercised in this case. Chiefly this is because constructive trusts are not remedial but institutional. Indeed, Lord Stephens stated that:

> *… the constructive trust (and the principal's beneficial ownership of the property) arises automatically at the moment that, in breach of their fiduciary duty, the directors received the secret profits. There was never a moment at which the former directors as fiduciaries owned the profits in equity.*

## Lessons for practitioners

A few key points can be taken away from this important decision:

- Where a director misuses a company's property and makes a secret profit, that profit belongs to the company which has a proprietary claim to the profit under a constructive trust.
- A third party cannot seek to oppose the company's claim to that secret profit by arguing that the director's illegal actions should be attributed to the company. The purpose and context of the relevant rule – the law of fiduciary obligations – means that attributing illegality in such a context would negate the rule entirely and cannot be allowed.
- It is possible that the proceedings could have been avoided had the CPS decided to prosecute VTL. Given the court's recognition of this option, it may be that in future the CPS will make sure to prosecute the company alongside its fraudulent directors, so as to obtain a confiscation order against the company directly.

## Cases Referenced

- Crown Prosecution Service v Aquila Advisory Ltd [2019] EWCA Civ 588
- Crown Prosecution Service v Aquila Advisory Ltd [2021] UKSC 49
- FHR European Ventures LLP v Cedar Capital Partners LLC [2014] UKSC 45; [2014] WTLR 1135 SC
- Jetivia SA v Bilta (UK) Ltd & ors [2015] UKSC 23
- Keech v Sandford [1726] EWHC Ch J76
- Meridian Global Funds Management Asia Ltd v Securities Commission [1995] UKPC 5
- Mothew (T/A Stapley & Co) v Bristol & West Building Society [1996] EWCA Civ 533
- Patel v Mirza [2014] EWCA Civ 1047; [2014] WTLR 1567 CA
- R (Best) v Chief Land Registrar [2015] EWCA Civ 17
- Re Norris [2001] UKHL 34
- Singularis Holdings Ltd (in liquidation) v Daiwa Capital Markets Europe Ltd [2019] UKSC 50

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